



Memorandum 12/2005

Commonwealth of Massachusetts | Public Employee Retirement Administration Commission
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MEMORANDUM

TO: All Retirement Boards

FROM: Robert A. Dennis, Investment Director

RE: Overview of Investment Regulation Issues

DATE: March 7, 2005

This memo is intended as a general reminder of some basic issues pertaining to the investment regulations.

First of all, except for investment in most successive venture capital partnerships, all new investment managers must be selected by a competitive process. Suggested places for competitive processes to be advertised include (but are not limited to) *Pensions & Investments* Magazine, the Massachusetts Public Pension Forum website, and the PERAC website. Copies of earlier PERAC investment education presentations on The Competitive Bid Process and How to Judge a Money Manager are available by contacting the Investment Unit. For those systems that do not employ an investment consultant, we are available to offer technical assistance in any phase of the competitive process, including the writing of RFPs.

All search processes should be advertised, but for those systems who are concerned with maximizing the breadth of their search process, it is important to note that they are not required to consider only those managers who respond to the advertisement. It is permissible for the board and/or its consultant to send copies of its RFP to targeted managers in hopes of soliciting responses from such managers. The active solicitation of prospective managers is applicable to all asset classes but it may be particularly important for boards seeking to hire index fund managers since some major vendors do not typically respond to RFPs.

Retirement boards must receive acknowledgement from PERAC that all necessary regulatory requirements have been received before commencing investment with a new manager. Boards should address any questions about the regulatory process to the Investment Unit.

As noted, investment in successive venture capital partnerships is generally permitted by Investment Guideline 99-3, but this guideline does not apply to real estate partnerships. However, PERAC will consider exceptions to the rule pertaining to real estate partnerships if a

compelling case can be made, such as instances where at least half of the invested proceeds in a preceding, similar recent partnership with the same manager has been returned to the board from the proceeds of liquidated properties from that partnership.

Periodic meetings with investment managers are an essential and expected aspect of the relationship between managers and their institutional clients; many large pension funds meet with their managers several times a year. In 2004, PERAC asked all retirement boards to provide confirmation that they have complied with investment regulations 16.07(2) and (3) that require annual performance review meetings with all investment managers and an annual determination that managers are satisfactorily fulfilling their mandates. We found reasonable compliance with these regulations by most systems and those systems that were not complying have begun to do so. Boards should provide us once a year with a listing of meetings held or scheduled to be held over the course of the year. Boards that prepare a schedule of manager meetings for the full year at the beginning of the year, rather than schedule them on an ad hoc basis, appear to have an easier time complying with these regulations. For those systems that do not employ an investment consultant, PERAC is pleased to offer assistance to boards that may have questions as to how to conduct investment manager reviews most effectively.

Boards are also reminded of the obligation to review brokerage and transaction costs as set forth in 840 CMR 16.05. In general, Boards are encouraged to review all PERAC Investment Regulations in order to insure that they are in compliance.

For boards making a transition from one manager to a new one, transaction costs---both in actual brokerage costs and in market opportunity costs --- may be a substantial consideration. Thus, it is always advisable for transitions to be as seamless as possible. However, when a board's mandate with a manager is suddenly or unexpectedly terminated by either party, leaving insufficient time to conduct a new search, PERAC will consider requests for temporary use of index funds in order for the board to maintain its asset allocation targets pending the completion of a search for a permanent replacement manager. In such instances, the board should contact a number of possible index fund providers and inform us of the basis---such as lowest fees--- for the selection of the particular manager.

As is done by many public pension funds and institutional investors, boards not already doing so should also consider index funds to be efficient low-cost vehicles by which to gain exposure to markets on a *permanent* basis. For systems whose active managers in a particular asset class consistently fail to meet or beat their benchmarks, the case for index funds is particularly compelling. As you may know, almost 40% of the PRIT Fund's assets are indexed.

The PERAC Investment Unit receives frequent calls from investment managers who are puzzled by certain questions they see on RFPs issued by retirement boards. For instance, many RFPs apparently ask whether the prospective manager is "approved" by PERAC in a particular asset class. Since there is no list of investment managers from which boards must choose, this type of question is inappropriate. If such a question is intended to inquire whether the prospective

manager currently manages money for any other Massachusetts retirement system, please clarify the language on the RFP. As mentioned above, we are happy to offer assistance to boards in the preparation of RFPs.

Boards are reminded that Investment Guideline 99-2 allows boards to request authorization to make modest modifications to their existing mandates with investment managers. Modifications envisioned by this guideline are of the magnitude suggested by going from Core Fixed Income to Core Plus Fixed Income. Broadening the mandate of a small cap equity manager to also manage large cap is generally beyond the scope of modest modification. Transferring from a separately managed fund to a commingled fund (or vice versa) with similar strategy run by the same manager is certainly permissible. Boards should contact the investment unit to discuss any questions pertaining to the application of this guideline.

At this time of year, managers have been reporting to their clients on their results for 2004; i.e., how they performed versus their benchmarks and the attribution of performance to certain strategies or specific investment decisions. A number of retirement systems are using benchmarks for overall portfolio performance that are no longer relevant to their actual portfolios. At a time when systems typically have a greater percentage of portfolio assets in stocks than in bonds, benchmarks such as “40% S&P 500, 60% Lehman Brothers Government/Corporate Index” are no longer reflective of expected performance. Systems should develop overall portfolio benchmarks that are generally consistent with current or target ranges for asset allocation.

Finally, although the headlines from the investigations into mutual fund trading improprieties have faded from the front page, boards are reminded of the importance of inquiring with current or potential investment managers about the firms’ code of ethics as it applies to the trading practices of portfolio managers and other ethical issues. Boards should also be sure that all performance data from managers is presented in a fair, accurate, and complete manner consistent with and in compliance with AIMR (Association for Investment Management and Research) standards.

The PERAC Investment Unit would be pleased to respond to any questions or requests for assistance on these or any other relevant matters. This unit closely follows trends and developments in all major financial markets as well as in overall pension fund investing and we also maintain data on benchmark returns in all asset classes. We encourage you to submit to us any investment-related questions that may be of interest to you. We are pleased to respond to specific research requests and would welcome the opportunity to make a presentation or attend a meeting at your office.